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USDOC FOR ITS/TD/ENERGY DIVISION

TREASURY FOR IA (LUYEN TRAN, RACHEL JARPE)

DOE FOR INTL AFFAIRS KDEUTSCH, ALOCKWOOD, AND GWARD

NSC FOR RICHARD MILES, DAN FISK

EXIM FOR MICHELE WILKINS

STATE PASS TO USTR (EISSENSTAT/MELLE)

STATE PASS TO FEDERAL RESERVE (ANDREA RAFFO)

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SUBJECT: ANALYSTS DISCUSS ECONOMIC DEVELOPMENTS IN MEXICO

REF: MEXICO 240

11. (SBU) SUMMARY: Market analysts are relatively upbeat about prospects for the Mexican economy due in part to high oil prices and domestic demand. Consumer price inflation is expected to increase again in May and June, and then begin falling slowly. Several local observers believe a watered down energy reform will be passed this year, and that nothing will come of the constitutional challenges against the Single Rate Corporate Tax (IETU). The Mexican Social Security Institute had to correct the way it measures formal employment because it had been overestimating job creation. An official at the Mexican Stock Exchange said the exchange will launch an initial public offering to list its own shares next month. END SUMMARY.

Prospects for Economic Growth

12. (SBU) Alberto Gomez, Banamex's chief economist, was relatively upbeat about prospects for the Mexican economy -- in part because the U.S. economy "is doing a little better than expected." He believes Mexico will grow by 2.6% this year. Mexico is weathering the U.S. slowdown better than in the past because high oil revenues allow the government to run countercyclical fiscal policy. Domestic demand is stronger than in the past, giving Mexico a buffer against the U.S.'s woes. Nonetheless, he believes that the U.S. slowdown will negatively affect the Mexican economy eventually because the link between the two economies is "simply too great." Alonso Rios and Arnulfo Rodriguez, officials from Accival (Banamex's brokerage arm), echoed Gomez's comments on growth, adding that they believe remittances from the U.S. to Mexico will be lower than the USD 24 billion recorded in 2007.

13. (SBU) The Accival officials said they are not concerned about Mexico having the same problems as the U.S. with the mortgage market because there are so many restrictions for granting loans. For example, a client has to give a down payment of at least 30% of the house's value (including credits from the government's housing development agencies),

and monthly mortgage payments should be no more than 30% of the person's income. The large down payment gives clients a strong incentive to continue paying even if the value of their house falls. Moreover, when Mexicans purchase a house, it is usually used as their primary residence -- not a second or third house. Finally, the mortgage market represents a small portion of the debt market.

Inflation and the Central Bank

14. (SBU) A Bank of Mexico (BOM) official told Econoffs he expects inflation to increase again in May and June, and then to begin falling gradually. Gomez agreed, saying that inflation would continue to rise in the near term due largely to pressure from processed foods. He does not believe that the BOM has room to adjust interest rates in the foreseeable future given recent inflation readings. He remarked that higher prices for food products (and a few other goods) have not yet contaminated other prices.

15. (SBU) The Accival officials told Econoffs that there is an ongoing debate between banks and the authorities regarding the easing of monetary policy to stimulate growth. Nonetheless, most analysts agree it would be difficult for the BOM to change its mandate to include fostering economic growth as long as it has difficulty keeping inflation near its 3% target. Rodriguez, who knows BOM Governor Ortiz, said Ortiz is a "conservative economist" who believes there should be an instrument for each economic situation. That is, Ortiz

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believes that the BOM should focus on inflation, while other government agencies should develop programs and implement structural reforms to spur economic growth. Separately, Rodriguez said that Calderon opposed Ortiz's appointment as BOM Governor because Calderon partially blamed Ortiz for the 1994-95 economic crisis.

Calderon's Reform Agenda

16. (SBU) Gomez and Banamex economist Sergio Luna told Econoff that energy reform would be passed -- probably in August during an extraordinary congressional session -- but said the reform will be even more watered down than the government's initial proposal. Alejandro Reynoso, the Managing Director of Corporate Strategy at the Mexican Stock Exchange (BMV), agreed that the reform would be passed, but was more critical of the proposal's contents. He said it is unclear what the government hopes to accomplish with energy reform because its proposal has "no game plan." Therefore, the proposal is open to criticism and unlikely to get support from the Mexican public. Reynoso lamented that there were not any brilliant people, like Finance Secretary Carstens, behind the reform package.

17. (SBU) Gomez believes that after energy reform is passed, the government will turn its attention to labor and, to some extent, competition reform. The latter will only happen "little by little." It will be a give and take process between the government and people like Carlos Slim. Gomez noted that the government has been defending Telmex in Ecuador and Venezuela, and that it will want concessions from Telmex for this support. Luna said that the head of the Federal Competition Commission's work of bringing competition problems to the attention of legislators cannot be understated. That said, Mexico still has a long way to go in terms of creating a culture of competition.

18. (SBU) Gomez believes the government will focus more on social issues in the run up to the midterm congressional election in 2009. Luna said the Institutional Revolutionary Party (PRI) wants more social programs run by the states, but

the federal government will resist this change because the political benefits associated with such programs would be credited to governors (the plurality of whom are PRI) versus Calderon's own National Action Party (PAN). Gomez added that no one really knows what reform the government will "pick" after these are complete.

¶9. (SBU) Neither Gomez nor the BOM contact thought that anything would come of the constitutional challenges against the Single Rate Corporate Tax (IETU). Local lawyers and Finance Secretariat officials have told Gomez they are optimistic the IETU will hold up.

¶10. (SBU) When asked to characterize President Calderon's approach to economic reform, Gomez responded that Calderon focuses on passing reforms that are politically feasible, even if they are not necessarily ideal. Luna asserted that Calderon wants to maintain the momentum for reform and build political capital so he is able to continue passing reforms during his last three years in office. Calderon is picking his fights and making allies. Alejandro Reynoso was more severe on the government, saying that so far Calderon only has completed former President Fox's reform agenda. He opined that the federal government has capitulated to entrenched interests (e.g. unions, monopolies, governors) and that he does not see movement toward weakening these groups' grip on power.

Government Admits Unemployment Stats Incorrect

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¶11. (SBU) The Mexican Social Security Institute (IMSS) acknowledged that it has been overestimating formal employment figures. According to estimates from BBVA Bancomer, 529,000 jobs were created in 2007, not the 756,000 jobs previously reported (and often used in the President's speeches). IMSS had been counting jobs that changed from temporary to permanent status as new jobs. IMSS has corrected its methodology and is supposed to release more revised figures next month. A Bank of Mexico official told Econoffs that he was not surprised when this news surfaced. He said some government officials have been questioning the calculations for some time.

Stock Exchange Prepares for Sell-off

¶12. (SBU) Reynoso told Econoffs on May 7 that the Mexican Stock Exchange (BMV) will launch an initial public offering (IPO) to list its own shares in June. (Note: The BMV announced plans to go public in 2006 but has repeatedly delayed the debut. End Note.) The prospectus is slated to be posted on May 19. As of now, two of the BMV's 25 shareholders have said they will sell some of their shares. The IPO was able to move forward because of four important factors: improved market conditions, new-found support from the BMV's board members for the IPO, the active role government authorities took in promoting the transaction, and the success of the Brazilian stock exchange's IPO. Recent steps to make the BMV Board more independent and transparent also helped. Proceeds will be channeled to integrate the BMV's sister companies (derivatives, stock market, etc.) into a holding company. It is expected that 30,000 small investors will be able to acquire the shares in financial markets.

¶13. (SBU) Reynoso said the IPO, together with steps to adopt corporate governance measures, will make the stock exchange "more democratic" and transparent. The general public will have access to the exchange's financial information and how it operates because it will be a public company. Reynoso remarked that the IPO will help break the "cartel of families

that used to run this business."

Fibras Get Off the Ground (Finally)

¶14. (SBU) Reynoso told Econoffs that another project that took a long time to become a reality was Mexico's version of real estate investment trusts (called Fibras). Companies were reluctant to issue Fibras because of the associated tax burden and because the vehicle was untested. Reynoso asserted that both issues have been resolved. Ironically, the first issuer of Fibras was the Mexico City government under PRD Mayor Marcelo Ebrard. The city government was attracted to Fibras because it is highly indebted and because it would not have to pay taxes on the transaction if it used this vehicle.

¶15. (SBU) Reynoso told Econoffs that the city issued a Fibra to tap into one of its highly valued assets that it cannot legally sell: subway stations. Mexico City's 17 inter-modal subway stations move around 4 million passengers a day -- making the areas immediately around them ideal locations for commercial establishments. The city created an entity called "Capital en Crecimiento" that will have the concession to create joint ventures with the private sector to operate these commercial facilities. Mexican businessmen -- including Carlos Slim, Moises Saba, the Chedraui family, and David Serur -- have expressed interest in participating.

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¶16. (SBU) Reynoso said that people are "paying attention" to Mexico City's Fibras. The federal government followed the same model to create its National Infrastructure Fund, and Carlos Slim is expected to list a Fibra within eight months for one inter-modal subway station, which will include not only commercial establishments but also a hospital and a hotel. Moreover, Nuevo Leon and the State of Mexico are interested in issuing Fibras. Interestingly, Reynoso said that Finance Secretary Carstens and Mexico City's Finance Secretary, Mario Delgado, cooperate behind-the-scenes on financial issues. Reynoso added that Carstens' show of respect for his counterparts fosters this cooperation.

Bio Notes

¶17. (SBU) When asked who President Calderon listens to on economic policy issues, Gomez listed Secretary of Social Development Ernesto Cordero, Under Secretary of Expenditures (and Calderon's former economic chief within the Office of the Presidency) Dionisio Perez Jacome, Finance Secretary Carstens, Under Secretary of Finance Alejandro Werner, and (to some extent) Economy Secretary Eduardo Sojo. Carstens gained a lot of credibility with the President because of the IETU, which is working well. Calderon also listens to business leaders and people such as Arturo Fernandez at ITAM. Gomez believes the President (who studied economics) takes in the opinion of others, and then makes his own decision. Alonso Rios told Econoffs he believes that Cordero is Calderon's closest economic advisor, but added that the President also listens to Carstens.

¶18. (SBU) The Accival officials and Reynoso suggested that Calderon could make Carstens the head of the central bank when Ortiz's term ends in 2009. Rios and Rodriguez remarked that Carstens has always wanted this position and that he was upset when he did not get a BOM deputy governor position before he went to the IMF. The Accival officials suggested that Cordero could replace Carstens as Finance Secretary since he has some financial experience from his time at Banobras (National Works and Public Services Bank). They noted, however, that analysts are a little worried because Cordero is so young and lacks experience in public

administration. Reynoso agreed that Cordero was a possible candidate to replace Carstens, but noted that "anyone" could end up getting the job.

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